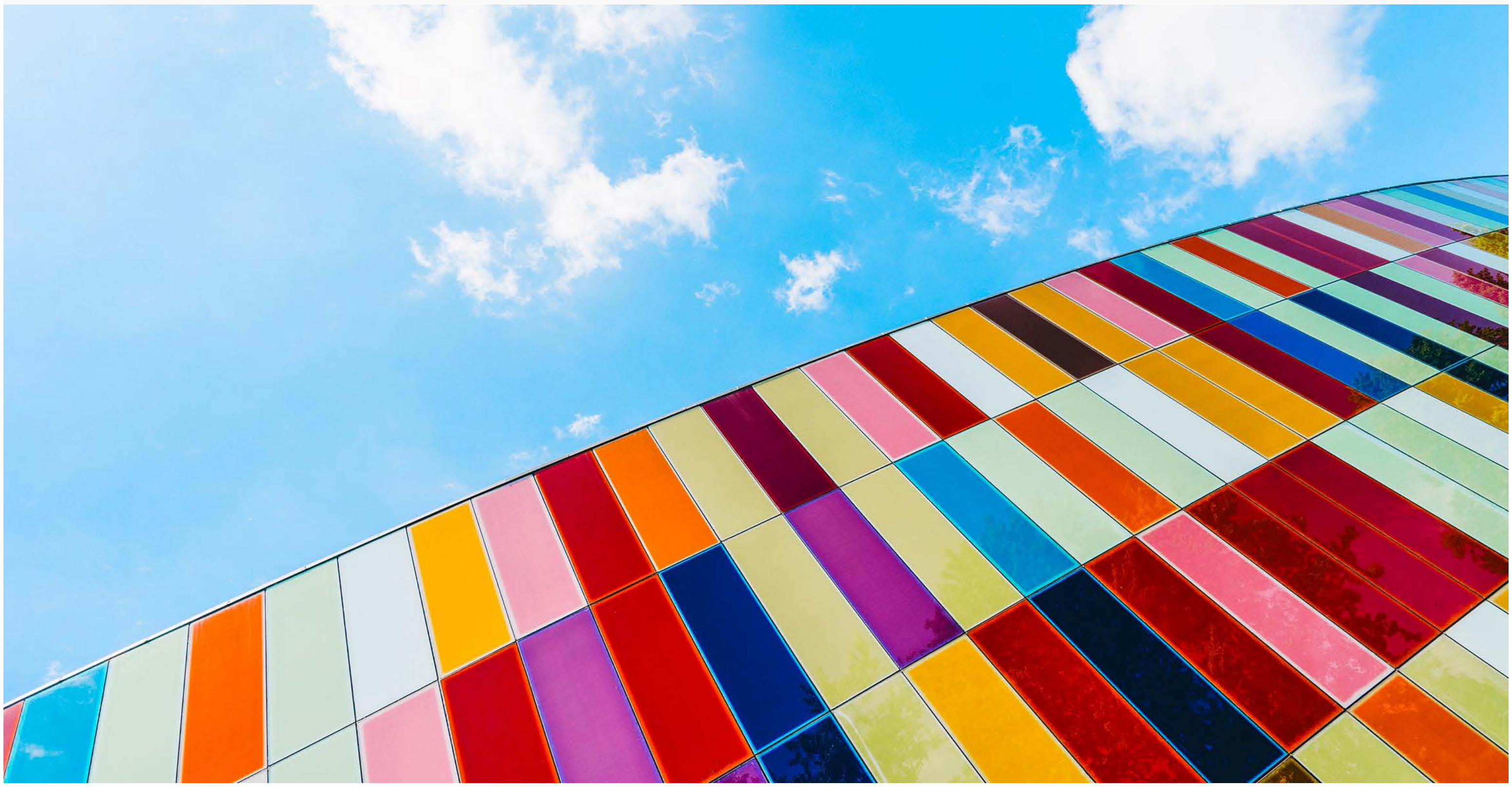
Menu Explore

Cooley PubCo

Thought leadership and curated content for the public securities arena

Cooley



Accounting and Auditing | Corporate Governance | Executive Compensation

Corp Fin has recently focused on the issue of corporate reporting and its impact on short-termism. At the end of last year, the SEC posted a "request for comment soliciting input on the nature, content, and timing of earnings releases and quarterly reports made by reporting companies." (See this PubCo post.) Following up, Corp Fin then organized a roundtable, held last week, to discuss the issues surrounding short-termism. The roundtable consisted of two panels: the first explored "the causes and impact of a short-term focus on our capital markets," with the goal of identifying potential market practices and regulatory changes that could promote long-term thinking and investment. In part, this panel developed into a debate about whether short-termism was actually creating a problem for the economy at all. In that regard, several of these panelists were quick to cite the oft-cited academic study revealing that "three quarters of senior American corporate officials would not make an investment that would benefit a company over the long run if it would derail even one quarterly earnings report." (See this PubCo post and this article in *The Atlantic*.) Could the reason be a misalignment of incentives? The second panel was centered on the periodic reporting system and potential regulatory changes that might encourage a longer-term focus in that system. Does the current periodic reporting system, along with the practice of issuing quarterly earnings releases and, in some cases, quarterly earnings guidance contribute to or encourage an overly short-term focus by managers and other market participants? On this panel, the headline topic notwithstanding, the discussion barely touched on short-termism; rather, the focus was almost entirely on regulatory burden. At the end of the day, is the SEC seriously considering making changes to periodic reporting?

(Based on my notes, so standard caveats apply.)

Echoing his remarks in connection with the announcement of the roundtable in May, SEC Chair Jay Clayton observed that the needs of "Main Street investors" must be the focus, and they are investing for the long term—for their retirements or other life events. As he noted in May, their needs have changed; they now have a longer life expectancy, and, in light of the shift from the security of company pensions to 401(k)s and IRAs, they now have greater responsibility for their own retirements. From that perspective, short-termism is problematic. However, from time to time, they also need liquidity and the SEC's disclosure system should foster both of these needs—long-term perspective and liquidity when needed. During the course of the panels, Clayton expressed his concern, notwithstanding the country's positive overall economic performance, that a changing dynamic was driving more companies to the private markets. There were now fewer benefits arising out of being public: while public companies still benefited from the "rigor" associated with being public, control had diminished under the current governance model, with more control exercised by shareholders (think hedge-fund activists). In addition, there were more disclosure requirements, which, while beneficial to investors, can also affect the way companies manage their businesses. At the end of the day, he was concerned that, in 10 years, the general public would not be able to participate in 70% of the economy because those companies would be privately held.

Capital markets panel. This panel began with an academic essentially questioning the roundtable's underlying premise: he did not believe that short-termism created a significant economic problem. In essence, he did not find evidence of the costs typically attributed to short-termism—declines in capex and R&D or an increase in stock buybacks. More specifically, he said that capex declined less in the U.S. than in any of the other OECD countries. Rather than buybacks killing cash, he argued that, with interest rates so low, it was economically sensible for companies to borrow funds to buy back stock, leading to a "massive recap" of public companies. With regard to R&D, that investment has been rising over the last 40 years. There has been a decline in only one sector, he said, government spending on basic research, which has declined by 20%. And that, he said, is significant because much of post-World War II growth in the economy developed out of basic government research. (Check out *The Fifth Risk* by Michael Lewis.) Looking at the issue from a macroeconomic perspective, he argued that, even if some companies have a problematic short-term focus, as long as others compensate by taking a long-term view, there is no problem across the economy. Moreover, he said, the market caps of many companies demonstrate a long-term focus because they are "justified" by their anticipated value in the future, not their current levels of profitability. In addition, he said, we should celebrate our vibrant private markets, not worry about it. Nor did he believe that the data on long-term returns following hedge-fund attacks (which was mixed) supported a view of hedge-fund activism as a cause of short-termism.

Lining up with the academic panelist was an institutional investor, who likewise did not view short-termism as a major problem. Rather, he characterized it as a "touchy issue" because there was a slippery slope between a legitimate long-term focus and a lack of accountability. In some cases, he said, when the market reacts negatively to company performance, the company deflects by telling the investors that their focus is too short term. The empirical data, he said, showed that a large percentage of unprofitable companies in the Russell 2000 are trading at record highs, basically on the expectation of future profits in the long term, echoing the point made by the prior panelist.

Taking the other side, another panelist described a recent survey of CEOs, in which 85% thought that short-termism was a problem. However, there was no consensus as to the reasons for it.

SideBar

Much has been written about the problems associated with the prevalence of short-term thinking in corporate America. There are, of course, many points of view with regard to the causes of short-termism, with blame attributed to, among other things, executive compensation (see this PubCo post and this PubCo post), pressure from Wall Street to increase quarterly results (see this PubCo post), traders' compensation (see *The Atlantic*), the "legal underpinnings" of capital markets regulation and the business model and prevailing culture of the investment management industry (see this PubCo post), caselaw regarding directors' fiduciary duties (see this PubCo post), and, perhaps most significant, hedge-fund activism (see this PubCo post).

In that survey, these CEOs expressed frustration with a market structure that they viewed as not conducive to long-term thinking. For example, the quarterly earnings call tends to dominate the discourse, they said, but it was challenge to refocus it toward the long term. The panelist, however, said that companies actually have more agency than they might think: by framing their disclosure and the context of their performance with a long-term focus, they may be able to "select" their own investors that share their long-term perspective. Another panelist observed that companies with a long-term orientation tend to prosper. Notably, however, in the 2008 financial crisis, these firms were punished more severely in the market, but also had stronger recoveries.

A corporate attorney on the panel contended that it was a mistake to look at the issue of short-termism from a macroeconomic level; after the 2008 crisis, reduced access to cash, as well as fear of approaches by hedge-fund activists, led many companies to increase their cash reserves instead of making long-term investments in the company and its employees. These investments, he observed, were not necessarily rewarded in the market. Activists tend to have a short-term focus and have pressured many companies —especially smaller companies—with cash reserves to return capital through buybacks or otherwise. He recommended that institutional investors that vote in favor of activists articulate the reasons for that decision.

Looking at the markets, another institutional investor indicated that, on the index side, the interests were primarily about governance and other long-term concerns; that was not necessarily the case, however, on the active trading side. He did see short-termism and the reduction in the number of public companies as a problem, but he did not see the problem as an "either/or." Rather, he said, public company boards needed to be more agile and manage for both the long term and the short term. He attributed the problem of short-termism to a misalignment of incentives, beginning with the confluence of deeply embedded incentive schemes that have long pushed short-term interests, including, for example, incentives on the market side that reflected the increased significance of trailing 12-month performance and, for companies, large components of equity compensation for management triggered by short-term performance goals. With that as the root cause, he suggested, an answer might lie in shifting the focus to long-term incentives. He indicated that some benefit might result from the new broker fiduciary rules and from the increased attention to long-term plan metrics and investor dialogue that have stemmed from say on pay. He also discussed the need for companies to promote their long-term strategies and marry those with investor needs, such as by laying out their core purposes and how they plan to address big trends and big risks. This type of disclosure would help provide a context in which investors could better judge "misses."

Similarly, another panelist described a potential framework for long-term disclosure, involving themes such as mega-trends (such as AI), plans regarding human capital and long-term capital allocation. In addition, it was suggested that companies give any guidance on a long-term basis, including ESG-related risks and opportunities. The panelist also suggested that building relationships with long-term investors could be a way to help fend off activists.

Another panelist advised that companies avoid quarterly guidance, suggesting that it was a myth that guidance lowered volatility or increased valuation; in her view, guidance just attracted short-term traders. She suggested focusing more on cumulative year-to date information. She also agreed that incentives were a major driver of short-term behavior and suggested long-term performance metrics and lock-ups for equity granted to board members. Another panelist countered that companies often say they have no choice but to give quarterly guidance because the competition is providing it.

In terms of suggestions for regulatory action, several panelists suggested that the SEC take steps to prevent or discourage quarterly guidance, which the regulators present acknowledged was not really in the cards. Alternatively, it was suggested that the SEC issue a statement that it was not required. One panelist suggested the SEC beef up the Schedule 13D disclosure and address proxy plumbing issues. (See this PubCo post.) Another panelist questioned whether the SEC could strengthen safe harbors for long-term projections.

Quarterly reporting panel. As noted above, there was very little attention on this panel to short-termism. No one seriously suggested that moving from quarterly to semiannual reporting would somehow be an antidote to short-termism. (That debate is discussed in this PubCo post.) Instead, the panel was primarily focused on the burdens associated with quarterly reporting and why it would be advantageous to reduce those burdens. The question came down to whether it would be preferable to streamline the 10-Q requirements or move to some type of semiannual reporting.

A panelist representing the Society for Corporate Governance reported that, in a survey of 250 respondents (1/2 small companies), 90% said that the 10-Q process is complex and burdensome, with the average company spending five months on these documents. Significantly, they also observed that the 10-Q is rarely impactful: the stock price is seldom affected and most of the questions emanate from the earnings release, not the 10-Q. Over 40% of these respondents would prefer a different “supplemental” approach that involved a reimagined 10-Q/earnings release process with an enhanced release and less comprehensive or less frequent 10-Q, but changed their views if they would need to “file,” as opposed to “furnish,” the 8-K that included the earnings release. One concern was that “filing” could chill disclosure.

Another panelist reported on a different survey showing that 17% of companies received a question on the 10-Q, while 52% received one to four questions. According to that survey, over 850 hours was spent on average each quarter complying with the process. Once again, the survey showed that the focus of investors is on the earnings release. Anecdotally, one panelist noted that, at his company, trading volume was usually three to four times higher on the day of the earnings release. Overall, many thought their time and money would be better spent elsewhere than on quarterly reporting. Over 70% indicated that they would prefer a more detailed earnings release rather than a 10-Q, or at least the availability of an alternative approach that involved a less prescriptive or less frequent 10-Q.

One panelist noted that the EU had moved from quarterly to semiannual reporting. Nevertheless, some companies still elected to report on a quarterly basis. But the option was available, and the flexibility especially benefited smaller companies. Perhaps a pilot program for smaller companies would be worth a try? Others suggested alternative methods of disclosure, such as company dashboards or a "company profile" system.

SideBar

The "company profile" approach was floated by former SEC Chair Mary Jo White back in 2013. That approach would have included a "filing and delivery framework based on the nature and frequency of the disclosures, including a 'core document' or 'company profile' with information that changes infrequently. Companies could then be required to update the core filings with information about securities offerings, financial statements, and significant events." (See this News Brief.) The same concept was recommended for further study and consideration in the staff's 2013 S-K Study, the *Report on Review of Disclosure Requirements in Regulation S-K*, required by Section 108 of the JOBS Act. It was later discussed, along with some countervailing considerations, by then-Corp Fin Director Keith Higgins in 2014 (see this PubCo post). But nothing materialized from these discussions.

There were several issues arising out of optional approaches that reduced the size or frequency of the 10-Q:

- What would be the role of auditors in review of the financials?
- What happens to the management certifications?
- Would the earnings release need to be "filed" (as opposed to the most common current

approach of "furnishing" the 8-K only)?

- How would incorporation by reference for Securities Act filings work?
- Where would the complete financials and footnotes be located?
- Where would the MD&A fit?
- And then, what about XBRL? (It was noted here that many issuers find XBRL expensive and very time-consuming and highly doubt its usefulness, not to mention that the SEC has just increased the XBRL burden for companies. Another panelist quoted an issuer as describing it as the "worst part" of the process.)

SideBar

As reported in this article from *Bloomberg BNA*, speakers at the American Accounting Association conference held in August 2018, including a FASB member and accounting technology experts, appear to have been downright hostile to XBRL (eXtensible Business Reporting Language). The FASB member was reported to have told the audience that, because some companies "don't finalize their XBRL tagging until nearly 60 days after they have filed their financial statements," the information arrives "too late for investors to use to for making decisions. So much other valuable analytical information has already become available, he said." Instead, he commented, more often, "analysts and investors are relying on earnings releases to make their decisions." Moreover, the development by companies of their own unique XBRL tags "has undermined a major purpose of XBRL—the ability to compare financial performance of companies involved in similar enterprises." He observed that "as many as five different tags can be created for the same piece of information. XBRL's lack of standardization makes comparing the same type of performance information impossible…" As a result, he reportedly concluded, XBRL has been rendered "nearly useless as an investment tool." For XBRL "to succeed in expanding data that provides an accurate picture of how a company actually performs," he said, "standardized methods to apply it to financial reporting must be devised." (See this PubCo post.)

> And, as discussed in this 2013 article in *Compliance Week*, "If You Build It, They May Not Come," a report from Columbia Business School suggested that the time-consuming and costly effort to implement XBRL "might have been a colossal waste of time." According to the report, the investors and analysts that were supposed to benefit from XBRL "don't seem to be using it. According to the report's authors,… analysts and investors remain skeptical about XBRL and have many concerns about its utility. The main complaint, according to the study, is that the data is still unreliable and fraught with errors. 'We could not identify any users or potential users who were comfortable with the reliability of the XBRL-tagged data currently available,' the authors write." Apparently, a major problem is that companies are still using too many company-specific tags, known as "extensions," rather than existing tags. Other problems identified in the report include the unavailability of XBRL for much of the other information that analysts use in their models and analyses, as well as the dearth of analytical tools that make use of XBRL. (See this PubCo post.)

On the institutional side, however, the 10-Q was viewed by a CII representative as important for transparency and for the discipline that the process brings. The preferred approach would be to streamline the 10-Q, but not reduce the disclosure of critical information or the frequency of reporting. To reduce the frequency of 10-Q reporting might reduce preparation costs, he said, but would certainly increase the cost of capital. However, a pilot program looking at a reduced frequency for a small subset of companies, such as small unlisted companies that were not heavily traded, might be a reasonable compromise. (And perhaps, the panelist suggested, governance and sustainability disclosure could be incorporated into any new framework?) Another panelist suggest that flexible frequency was a kind of red herring, at least for larger companies, which might regularly conduct stock buybacks or other transactions that would require quarterly disclosure. Concerns were also raised about investor trust in the markets.

An accountant on the panel noted that the rarity of changes from the earnings release to the 10-Q attested to the quality of earnings releases. (Not all agree with his take. See this piece from *MarketWatch.)* In his view, streamlining the 10-Q could lead to more innovations. For example, he suggested that, consistent with Article X of Reg S-X, the 10-Q should really be viewed as more of an update of the 10-K. That would mean more focus on year-to-date information rather than quarterly information, without the need for two sets of financial statements and two sets of notes, reducing redundancy and introducing more of a long-term bias. Summary quarterly information could be included in the 10-K instead. The approach was likened to reporting the score in a football game—you don't really care much about the score in each quarter, just the cumulative score. In that same vein, other panelists concurred with the YTD approach and also suggested more aggressive streamlining, for example, through simplifying the notes, permitting disclosure of information through other means, and revisiting XBRL. It was also suggested that the SEC use its bully pulpit to advocate streamlining. As a first step, perhaps public companies should ask their investors what types of information they really needed?

In addition, with regard to frequency, the accountant observed that the rigor and management controls associated with quarterly reporting help to identify problems on a timely basis. One possibility, however, was to allow a reduced level of reporting for some quarters, such as a less robust first and third quarters, while maintaining the same rigor and controls. On the other hand, it was noted that that approach could create comparability and asymmetry issues.

When asked about the impact of quarterly guidance, the CII representative suggested that it unduly incentivized short-termism. Another panelist contended that companies would happily forego guidance—the question was really one of expectation. An attorney on the panel suggested that the problem was not guidance but rather quarterly earnings hysteria in the market; however, he acknowledged that, unfortunately, the SEC had only a limited mandate here and no real toolbox. The SEC, he suggested, should study the incentives promoting this hysteria. The representative from the Society for Corporate Governance suggested that analysts would still give estimates, so even if guidance were not provided, short-termism would still flourish. Another suggestion was for the SEC to require meaningful disclosure regarding short sales.

SideBar

In this *WSJ op-ed*, investor Warren Buffett and JPMorgan CEO Jamie Dimon advocated a move away from quarterly *guidance*, but reaffirmed their support

> for quarterly *reporting.* (See this PubCo post.) In addition, a group of prominent CEOs of major public companies and institutional investors have developed a list of "commonsense corporate governance principles," designed to generate a constructive dialogue about corporate governance at public companies. With regard to earnings guidance, the group maintained that a "company should not feel obligated to provide earnings guidance—and should determine whether providing earnings guidance for the company's shareholders does more harm than good. If a company does provide earnings guidance, the company should be realistic and avoid inflated projections. Making short-term decisions to beat guidance (or any performance benchmark) is likely to be value destructive in the long run." It's worth noting here that many smaller companies feel compelled to provide earnings guidance or risk loss of analyst coverage. With regard to quarterly reporting, the view of the group was that companies "should frame their required quarterly reporting in the broader context of their articulated strategy and provide an outlook, as appropriate, for trends and metrics that reflect progress (or not) on long-term goals." (See this PubCo post.)

Interestingly, Chair Clayton seemed to be entertaining the possibility of making some kind of change. If it's rare that the market moves on filing of the 10-Q if the release was issued earlier, then what is the market telling us, he questioned? Can this process be done more efficiently? In other OECD markets, the level of disclosure is narrower and less detailed and some report on a semiannual basis, yet there is no resulting market discount. Of course, he said, the time spent by private companies on financial reporting is less—and should be less—but should it be five times less? Another factor to take into account, he observed, is that we now have more of a continuous disclosure system than we had 20 or so years ago. Can we achieve a more efficient process without a decrease in rigor?

Posted in: Accounting and Auditing, Corporate Governance, Executive Compensation, Securities
Tagged in: Form 10-Q, semiannual reporting, short-termism, XBRL

share this